RBC Global Asset Management

Market Update

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New Year 2020 outlook: Boosting equity allocation as economy stabilizes, downside risks diminish

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The global economy is showing signs of stabilization after nearly two years of deceleration. Leading indicators of growth are bottoming (Exhibit 1) and, while the business cycle is indeed mature, traditional gauges of recession risk over the year ahead have become less acute. The bulk of the economic slowdown over the past two years stemmed from manufacturing weakness related to protectionism and business confidence. As various macro threats diminish, consumers have remained healthy and spending is likely to continue fueling the expansion.

Downside risks remain, but they have shrunk

A number of challenges could still disrupt our positive outlook, but downside risks have arguably shrunk given progress on Brexit, trade and Chinese stimulus. The odds of a no-deal Brexit have declined and U.S.-China relations have improved as negotiations move toward finalizing a phase-one deal. In our view, the worst-case outcomes we had feared in prior quarters are now less likely to materialize.

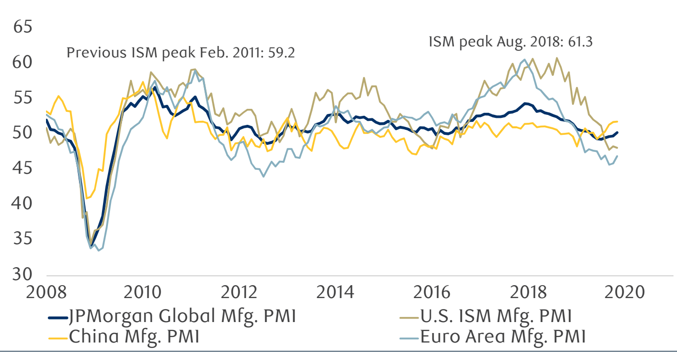
Central banks deliver stimulus

Also helping the economy is the fact that central banks have eased monetary policy so far this year. The Fed delivered three cuts since July and is once again expanding its balance sheet, purchasing short-term Treasuries at a rate of US$60 billion per month. In Europe, the ECB cut rates to -0.50% from -0.40% and also restarted a 20 billion euros per month bond-purchase program. Several other global central banks have also cut rates to stimulate their economies, and the broad-based easing of financial conditions is likely to support both economic growth and investors' appetite for risk-taking.

Global bond yields rebound

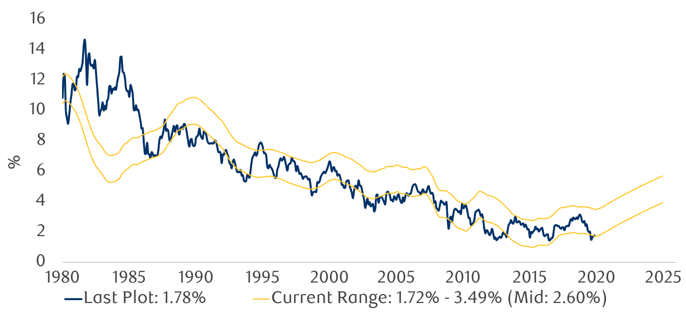
Bond yields bottomed in the summer/fall of 2019 as the prospect of stabilizing/better economic growth reduced the demand for safe-haven assets. The U.S. 10-year yield has been climbing irregularly from its low of 1.45% in September but remains below our estimated equilibrium level (Exhibit 2).

Exhibit 1: Global purchasing managers' indices



Note: as of November 29, 2019. Source: Haver Analytics, RBC GAM

Exhibit 2: U.S. 10-year T-bond yield
Equilibrium range



Note: as of November 29, 2019. Fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index. Source: RBC GAM, RBC CM

Although a variety of structural headwinds continue to depress real interest rates (i.e. demographics and shifting preferences in saving versus spending), should the economy's pulse quicken bond yields are likely to continue rising, generating unimpressive returns for sovereign bonds particularly outside of North America.

Stock-market rally is broad-based and being led by economically sensitive sectors

Reversing much of the damage from 2018, global equities have enjoyed a powerful and broad-based rally in 2019, with economically-sensitive sectors and investment styles leading the charge in the second half of the year. Cyclicals, for example Financials, began to outperform defensives, and value stocks have led growth stocks since August 2019 (exhibits 3 and 4). This rotation in leadership has in the past come in advance of an improving economy and a sustained rally in risk assets.

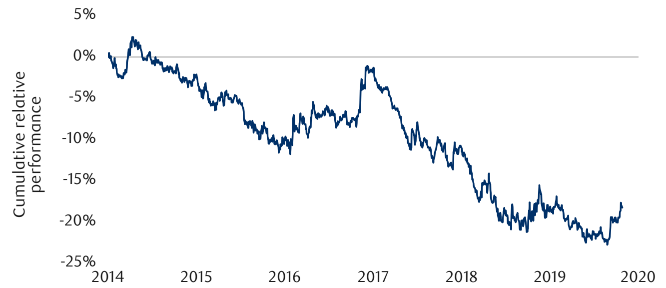
U.S. equities climb above fair value but other markets are attractively priced

Expanding multiples have been the main source of returns so far in 2019 as investors price in an eventual rebound in earnings growth. The S&P 500 Index has gained over 25% this year and climbed above our modelled estimate of fair value while earnings growth has been flat (Exhibit 5). Looking ahead, analysts expect corporate profits to grow at relatively normal mid-to-high single-digit rates, which suggests a reasonable possibility of mid-to-high single-digit equity-market returns over the year ahead. However, U.S. equities being above fair value has historically been associated with higher levels of volatility and represents a vulnerability for stocks should profit growth fail to recover. After a decade of lagging performance, equities in Europe, Asia and Emerging Markets continue to trade beneath fair value (Exhibit 6).

Asset mix – boosting equity allocation versus a quarter ago

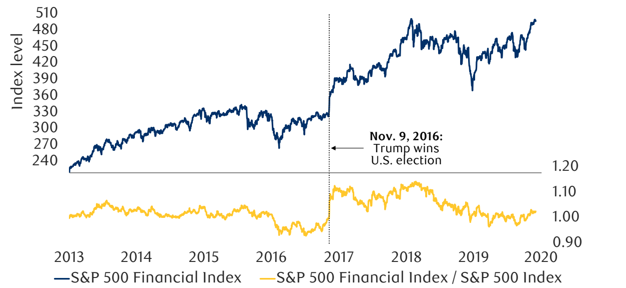
In our view, the economy is likely to continue expanding over our 12-month horizon and, against this backdrop, we expect stocks to outperform bonds. While challenges remain, during the past quarter we became more constructive on the outlook for risk assets given fading headwinds related to Brexit and trade, yield curves that are no longer inverted and the persistence of the market rotation into economically-sensitive sectors and styles. As a result, we boosted the equity allocation in our portfolios over the period, adding two percentage points to stocks in our model asset mix, sourced from cash. Our current recommended asset mix for a global balanced investor is 59.0% equities (strategic: "neutral": 55%), 40.0% bonds (strategic "neutral": 43%) and 1.0% in cash.

Exhibit 3: Value to growth relative performance
S&P 500 Value Index / S&P 500 Growth Index



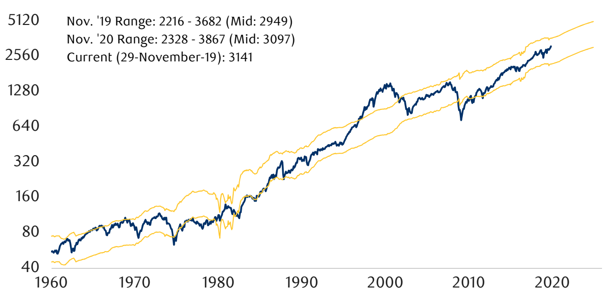
Note: as of November 29, 2019. Source: Bloomberg, RBC GAM

Exhibit 4: S&P 500 Financial Index
Index level and relative strength



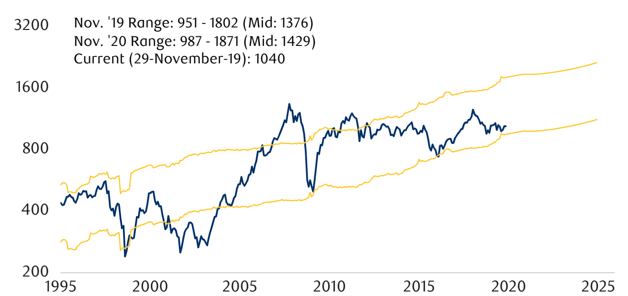
Note: as of November 29, 2019. Source: Bloomberg, RBC GAM

Exhibit 5: S&P 500 equilibrium*
Normalized earnings & valuations



Note: as of November 29, 2019. Source: RBC GAM

Exhibit 6: MSCI Emerging Markets equilibrium*
Normalized earnings & valuations



Note: as of November 29, 2019. Source: Consensus Economics, RBC GAM

* Fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index.

Disclosure

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